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In The Supreme Court of the United States

October Term, 1987

Duquesne Light Company
and
Pennsylvania Power Company
Appellants,

v.

David M. Barasch,
Consumer Advocate, et al.
Appellees.

On Appeal from the Supreme Court of Pennsylvania

Brief for Appellee, David M. Barasch, Consumer Advocate

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QUESTIONS PRESENTED

1. Where a public utility appeals a rate decision with respect to a single item in the rate calculation, but fails to demonstrate, or even allege, that the decision will have a significant adverse impact upon the utility's overall rate level or resulting financial condition, can the utility claim that the decision is confiscatory in violation of the Fifth and Fourteenth Amendments?

2. Where this Court's holdings have made it clear that it is the overall result reached, not the method employed, which determines whether a public utility rate order can be challenged as confiscatory, can a utility attack a single provision of a state public utility code on the ground that the ratemaking method mandated by that provision is unconstitutional?

3. Where a state statute codifies longstanding state ratemaking principles which prohibit utilities from charging their ratepayers for the costs of useless investments, is such a law unconstitutional on its face or as applied to a utility's investment in a failed construction project which never has and never will provide service to anyone?

4. Can the General Assembly of Pennsylvania require the Pennsylvania Public Utility Commission to exclude the costs of useless investments from utility rates as a matter of law, where that law is part of a public utility code which requires that the rates of all public utilities must be just and reasonable?

5. Where a provision in a state ratemaking law requires a public utility commission to exclude the costs of certain useless investment in setting just and reasonable rates, is such a provision so irrational or unrelated to any valid state policy that it violates the Due Process Clause of the Constitution?

6. Does the constitutional prohibition against confiscation require the ratepayers of a regulated utility to bear the costs of a failed construction project which is voluntarily cancelled by the utility before the project is completed?

7. Should this Court overturn 44 years of established case law and create a single constitutional rate method under which utilities would be guaranteed a return on all "prudent" investment, regardless of whether that investment is needed, economical, or useful in the provision of service to ratepayers?

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Brief for Appellee, David M. Barasch, Consumer Advocate

Appellee, David M. Barasch, Consumer Advocate (hereinafter, Office of Consumer Advocate or OCA)[1] files this Brief in opposition to the Brief of Appellants, Duquesne Light Company and Pennsylvania Power Company. The OCA respectfully urges this Honorable Court to affirm the Order of the Pennsylvania Supreme Court dated October 15, 1987, which is the subject of this appeal.

[1]The OCA is an agency of the Commonwealth of Pennsylvania authorized to represent the interests of Pennsylvania utility consumers before the Pennsylvania Public Utility Commission and other state and federal agencies and courts which regulate the activities of Pennsylvania's public utilities. 71 Pa. Stat. Ann. §309-1 *et seq.* (Purdon Supp. 1987). The OCA has represented the interests of the ratepayers of Duquesne Light Company and Pennsylvania Power Company throughout the proceedings which have given rise to the present appeal. Appellee, David M. Barasch, has served as the Consumer Advocate of Pennsylvania since 1984.

STATEMENT OF THE CASE

This is an appeal by two electric utilities from a Pennsylvania Supreme Court Order which found that the Pennsylvania Public Utility Commission (hereinafter, PUC or Commission) had erred as a matter of law by requiring ratepayers to bear the costs associated with four power plants which were voluntarily abandoned prior to completion and which therefore never provided service to those ratepayers.

In two general rate increase proceedings before the PUC, the utilities involved, Duquesne Light Company (hereinafter Duquesne) and Pennsylvania Power Company (hereinafter Penn Power), requested and received the right to recover from ratepayers, over a ten-year period, all money invested by the utilities in the abandoned projects. These rate allowances were appealed by the OCA, but were initially upheld by a 4-3 vote of the Commonwealth Court of Pennsylvania.

The Commonwealth Court Order was reversed by the Pennsylvania Supreme Court, which unanimously ruled in an Opinion by Chief Justice Nix that the PUC rate orders had violated the Pennsylvania Public Utility Code. Specifically, the Supreme Court agreed with the OCA's position that the allowance of rate recovery of the cost of a cancelled power plant violated Section 1315 of the Public Utility Code, 66 Pa. Cons. Stat. §1315 (1987). That provision states, with certain exceptions not pertinent here, that:

> the cost of construction or expansion of a facility undertaken by a public utility producing, generating, transmitting, distributing or furnishing electricity shall not be made a part of the rate base nor otherwise included in the rates charged by the electric utility until such time as the facility is used and useful in service to the public.

Section 1315 further states that:

> Except as stated in this section, no electric utility property shall be deemed used and useful until it is presently providing actual utility service to the customers.

Because there was no dispute that the abandoned plants at issue never have and never will provide actual service to customers, the Supreme Court agreed with the OCA's position that, as a matter of state law, the costs of those plants could not be charged to ratepayers. The Court also noted that this interpretation of Section 1315 was consistent with "the fundamental principles of this state's public-utility jurisprudence", *i.e.*, that "no utility of any type is permitted, without express and valid legislative authorization, to charge ratepayers for property which is not used and useful in the production of current utility service." 532 A.2d 325, 338 (App. 28a-29a).[2] Finally, the Court rejected the utilities' claims that the disallowance of these costs from rates was violative of the Pennsylvania Constitution or the United States Constitution. 532 A.2d 325, 335-39 (App. 21a-31a).

The Pennsylvania Supreme Court did not order any specific changes in the utilities' rates, but rather remanded the matter to the Commission for proceedings consistent with its Opinion. 532 A.2d 325, 339 (App. 31a). Duquesne and Penn Power then took the present appeal to this Court.

Before addressing the Companies' arguments, certain additional points should be noted.

First, as stated by Duquesne and Penn Power in their Brief at 4, the four plants at issue here were cancelled in January, 1980, prior to the issuance of a construction permit by the Nuclear Regulatory Commission. Thus, only "pre-construction" expenditures for such items as engineering and siting analyses are at issue here. *Id.*

For Duquesne, the total pre-construction costs claimed for these

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[2]By order dated April 18, 1988, this Court granted Appellants' Motion to Dispense with Printing of the Joint Appendix. All references to "App." are to the Appellants' Appendix to Jurisdictional Statement.

projects amounted to $34,697,389. (App. 37c). The annual expense allowance permitted by the Commission for the ten-year amortization of this amount was $3,469,739. *Id.* This allowance was a relatively small component of an overall rate increase of $105,850,000, which brought Duquesne's total annual revenue allowance from its Pennsylvania jurisdictional ratepayers to $802,463,063. (App. 126c).

Penn Power's share of the costs amounted to $9,569,665, with the annual amortization allowance equal to $956,967. (App. 81e-82e). This allowance was part of a $15,364,000 rate increase, which raised Penn Power's annual allowed revenues to $184,186,000. (App. 3e-4e).

Next, it should be noted that the majority of the ownership in these four abandoned units was held by three Ohio utilities. As in Pennsylvania, the Ohio Public Utilities Commission initially permitted the recovery of the costs of these units from ratepayers, but that allowance was overturned as violative of state law by the Ohio Supreme Court. *Office of Consumers' Counsel v. Public Utilities Commission*, 67 Ohio St. 2d 153, 423 N.E.2d 820 (1981). The appeal of Cleveland Electric Illuminating Company (CEI) from that Ohio Supreme Court decision — as well as CEI's subsequent appeals from two related orders regarding this same issue — were summarily dismissed by this Court at 455 U.S. 914 (1982), 459 U.S. 1094 (1983), and 464 U.S. 802 (1983).

Finally, the OCA would note that the Appellants in this case were not *ordered* by the PUC or any other regulatory authority to commence construction of the generating plants at issue here. Nor were Appellants *ordered* by any regulatory authority to cancel the units prior to completion. The decisions to commence and to cancel construction of these units were both voluntarily made by the Appellants.

Because of their monopoly status, the Appellants, and all similarly situated Pennsylvania utilities have a statutory obligation

to provide safe and adequate service to all retail electricity customers within their respective service territories. *See* 66 Pa. Cons. Stat. §1501 (1987). However, the manner in which the Appellants meet this obligation to serve is generally a matter of broad management discretion.

During the period in question, Pennsylvania law did *not* require the advance approval of construction decisions. Nor did the Appellants ever seek such approval with respect to the plants involved in this case. Neither did the Appellants seek or obtain advance approval of their decision to cancel the four units. The PUC orders at issue here (Appendices C, D, E, and I) all involved reviews of the Appellants' prior decisions to commence and then to cancel the plants, and the ratemaking treatment which should be accorded to the costs incurred during the period between those decisions.

The Appellants suggest at page 3 of their Brief that they, along with other Pennsylvania utilities, were "instructed" to add capacity in a PUC Order issued in 1972. *Investigation of the Need for Additional Electric Generating and Transmission Facilities*, 46 Pa. P.U.C. 23 (1972). This suggestion is incorrect. In the Order referenced by the Appellants, the PUC did express serious concern over "whether or not an electric energy shortage will develop" in Pennsylvania, but the Commission also questioned whether "the industry's construction program calls for excessive capital investment at the expense of existing rate paying customers." 46 Pa. PUC at 26. The Order did not require the Appellants to build any additional generating capacity, nor did it make any reference to the specific units at issue here. Rather, the Order directed the Appellants and their fellow Pennsylvania electric utilities to file annual reports with the PUC detailing their existing generating plants and setting forth their specific plans to meet customer demands over the succeeding ten years. *Id.* at 26-27.

SUMMARY OF ARGUMENT

In order for the Appellants to prevail in this case, this Court would have to overrule the fundamental principles that have guided the constitutional review of utility rate decisions since *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). The Court in *Hope* ruled that, in reviewing a utility rate order, "it is the result reached not the method employed which is controlling" and that "[i]f the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end." 320 U.S. at 602.

Under *Hope* , a utility cannot even *claim* confiscation in the ratemaking context unless the *overall* rates allowed fail to satisfy the investor interests identified in that decision. A utility has no constitutional right to recover the costs of specific investments. Nor does a utility have a constitutional right to demand the application of any particular ratemaking methodology.

In the present case, the Appellants have not even alleged, let alone demonstrated, that the relatively minor rate disallowances involved in this appeal will have *any* substantial negative impact upon the utilities' overall rates or resulting financial conditions. Instead, the Appellants have challenged the constitutionality of the ratemaking method employed — an issue which this Court repeatedly has stated it will not consider in a utility rate appeal. As such, the Appellants have failed to meet the threshold requirements under which this Court will consider a confiscation claim in the context of a utility rate case. The appeal therefore should be rejected.

To the extent the Court reaches the substantive arguments raised by the Appellants, the OCA submits that those arguments are wholly without merit.

The "used and useful" principle which is challenged by the Appellants remains constitutionally valid after *Hope*. Indeed, *Hope* makes it clear that no particular rate methodology is either constitutionally forbidden or constitutionally required. The principle that ratepayers should not be required to bear the costs of investments

that do not serve them has been a fundamental theme of most state and federal ratemaking methodologies both before and after the Court's decision in *Hope*. While not constitutionally *required*, the used and useful principle is eminently sensible and is clearly constitutionally *permissible* in light of this Court's holding in *Hope*.

The Pennsylvania General Assembly is not barred from establishing the used and useful principle as a matter of statutory law, particularly where that principle is part of the overriding requirement of Pennsylvania law that the rates of all public utilities must be just and reasonable. State legislatures may prescribe specific ratemaking rules to be followed by their designated administrative arms, the state public utility commissions. The specific statute at issue here codified longstanding principles of state public utility law which protect ratepayers from bearing the costs of useless utility investments. Certainly, the legislation passes the requirements for state economic regulation under the Due Process Clause of the Fourteenth Amendment to the United States Constitution.

Neither the challenged legislation, nor the order in this case is confiscatory under the analysis set forth in this Court's recent "takings" jurisprudence. The Appellants voluntarily abandoned work on four power plants and *then* sought "compensation" through the ratesetting process for an investment which was rendered worthless entirely by their own action. The nature of the government regulation here was clearly non-intrusive and the economic impact was minimal. To the extent that investors expected that they would have a right to recover these costs from ratepayers, those expectations were based on misconceptions concerning the applicable Pennsylvania and constitutional law.

This Court should not adopt the "prudent investment" standard — or any other single ratemaking methodology — as the sole constitutionally permissible rate method. The Appellants and their Amici have misinterpreted the prudent investment standard and have recommended an approach which would render unconstitutional the ratemaking frameworks of most state and federal regulatory authorities.

ARGUMENT

I. THE APPELLANTS HAVE FAILED TO MEET THE THRESHOLD REQUIREMENTS FOR CHALLENGING THE CONSTITUTIONALITY OF A UTILITY RATE ORDER.

A. Introduction

While the Appellants purport to base their argument in this case on this Court's landmark decision in *FPC v. Hope Natural Gas Co.*, 320 U.S 591 (1944), it is clear that the appeal can be sustained only if this Court disregards or overrules the fundamental teachings of that case.

Hope marked the end of an era of judicial intervention in utility ratemaking decisions in which the courts, including the lower court in the *Hope* case, had ruled that, as a matter of constitutional right, the "fair value" of the property on which a utility's rates were set had to include some measure of present value or reproduction cost, rather than be based upon the original or historical cost of the property.

The Court in *Hope* thus adopted the view of the concurring opinion of Justice Douglas (the author of the *Hope* opinion), Justice Black and Justice Murphy in *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 607 (1942), that:

> Irrespective of what the return may be on "fair value," if the rate permits the company to operate successfully and to attract capital all questions as to "just and reasonable" are at an end *so far as the investor interest is concerned.*

(emphasis added).

The Court in *Hope* ruled that for purposes of its review, "it is the result reached not the method employed which is controlling"

and that "[i]f the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end." 320 U.S. at 602.

These principles have been consistently observed by this Court in its ratemaking decisions subsequent to *Hope*, yet they are totally ignored or misconstrued by the Appellants here. Appellants have brought an appeal to this Court which challenges, on constitutional grounds, the ratemaking methodology employed in determining only one component of their respective overall rates. Moreover, Appellants raise this issue without even alleging, let alone demonstrating, that the Order below will have any substantial negative impact on the Appellants' overall rates or financial conditions. As such, the Appellants have failed to meet the threshold requirements established in *Hope* under which this Court will consider a confiscation claim in the context of a utility rate case.

B. The Appellants Have Failed To Allege That The Pennsylvania Supreme Court Order In This Case Will Have A Substantial Negative Impact On Their Overall Rates Or Financial Conditions. They Therefore Have No Constitutional Basis On Which To Assert That The Order Is Confiscatory.

In their statement of the first question presented, the Appellants ask this Court to determine whether the Pennsylvania Supreme Court's interpretation of the state law at issue in this case effects an unconstitutional taking "by precluding the state ratemaking agency from considering constitutionally pertinent factors *in determining whether to permit recovery of prudently incurred investment in cancelled electric generating units.*" (emphasis added).

The fundamental flaw in the premise to this question — and the flaw which pervades the Appellants' entire Brief — is the misconception that utility investors have a constitutionally protected interest in the recovery from ratepayers of the costs of *specific* items of investment, rather than in the *overall* justness and reasonableness of the rate levels established for the utility.

Nowhere in their Brief do the Appellants address the impact of the Pennsylvania Supreme Court Order on the companies' overall rate levels or upon their overall financial standing. Yet, it is beyond dispute under this Court's *Hope* decision that a showing of financial harm is the threshold requirement that a utility must meet in order even to present a "takings" claim in the ratemaking context.

The *Hope* decision made it clear that utilities may not challenge a rate order as unconstitutional on the grounds that individual components of the order were deficient. Rather, the Court said, it will *first* look to the *overall impact* of those decisions on the utility. As stated by the Court:

> If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end.

320 U.S. at 602.

This fundamental holding of the *Hope* decision is illustrated most clearly by the Court's treatment of the specific issues raised before it in that case. After finding that the "end result" of the rate order in that case could not be condemned as unjust and unreasonable "from the investor or company viewpoint", 320 U.S. at 603, the Court refused even to consider the utility's claim that the rate base established by the FPC was understated by $17 million. As stated by the Court:

> In view of this disposition of the controversy we *need not stop to inquire* whether the failure of the Commission to add the $17,000,000 of well-drilling and other costs to the rate base was consistent with the prudent investment theory as developed and applied in particular cases.

Id. at 605-06 (emphasis added). It should be noted in this regard that the total rate base *allowed* in the *Hope* case was just $33.7 million. *Id.* at 596. Yet, because the company failed to show that the overall end result of the rate order was unjust and unreasonable to the investors, the Court found it unnecessary even to address the merits of its additional $17 million rate base claim.

The constitutionally pertinent standards set forth by this Court in Hope and the predecessor *Natural Gas Pipeline* decision were summarized by Justice White in his Opinion for the Court in *FPC v. Texaco Inc.*, 417 U.S. 380, 391-92 (1974), as follows:

> *All that is protected against*, in a constitutional sense, is that the rates fixed by the Commission be higher than a confiscatory level. *FPC v. Natural Gas Pipeline Co.*, 315 U.S., at 585. In the context of the Act's rate regulation, whether any rate is confiscatory, or for that matter "just and reasonable," can only be judged by "the result reached, not the method employed."

(*quoting Hope*, 320 U.S. at 602 (emphasis added)). Justice White reiterated this statement in his Opinion for the Court in *FERC v. Pennzoil Producing Co.*, 439 U.S. 508, 519 (1979). Justice White also reasserted in that case the position articulated by the Court in *Natural Gas Pipeline* and the *Permian Basin Area Rate Cases*, 390 U.S. 747, 770 (1968) that a rate which fell within a "broad zone of reasonableness" permitted by the Natural Gas Act "cannot properly be attacked as confiscatory." *See also, FPC v. Conway Corp.*, 426 U.S. 271, 278 (1976) ("[T]here is no single cost-recovering rate, but a zone of reasonableness."); *Montana-Dakota Utilities Co. v. Northwestern Public Service Co.*, 341 U.S. 246, 251 (1951) ("Statutory reasonableness is an abstract quality represented by an area rather than a pinpoint. It allows a substantial spread between what is unreasonable because too low and what is unreasonable because too high.")

In the present case, the Appellants have not alleged — nor could they allege — that the disallowance of their claims for cancelled plant costs would turn the *overall* substantial rate increases granted in these cases from a constitutional to an unconstitutional "end result." It would be an exceedingly small "zone of reasonableness" if this Court were to hold, as a matter of constitutional law, that the $105.8 million annual rate increase granted by the Commission

in the Duquesne rate case would be transformed into an unconstitutional taking if that increase were reduced to $102.4 million as a result of the disallowance of the Company's abandoned plant claim. Similarly, Penn Power could not reasonably allege that the disallowance of less than $1 million from its $15.4 million rate increase in this case would render the overall end result unconstitutional.

In the rate case here on appeal, Duquesne Light Company was authorized to earn a 16.14 percent common equity return and 11.64 percent overall return on a rate base of nearly $1.8 *billion*. (App. 19c, 93c). The total allowed annual revenues to the Company resulting from the $105.8 million rate increase exceeded $800 million. (App. 126c). Clearly, the $3.5 million annual amortization for cancelled plant costs which would be disallowed under the Pennsylvania Supreme Court's Order would have a relatively minor effect on the "end result" of the Commission's Order.

Similarly, in its rate case, Penn Power was authorized to charge a 15.72 percent return on common equity and a 12.02 percent overall return on a rate base of approximately $400 million. (App. 5e, 48e). The Company's $15.4 million rate increase in this case brought its total annual revenues to $184.2 million. (App. 3e, 4e). Penn Power's annual amortization claim for the cancelled plants at issue here amounted to $956,967. (App. 81e-82e).

The OCA has *not* contended, as asserted by Appellants at page 18, note 17, of their Brief, that *Hope* eliminates constitutional review of state rate orders "unless the impact of such an order is to bring the regulated utility to the brink of bankruptcy." The OCA does submit, however, that *Hope* establishes a threshold requirement for claiming confiscation in the utility ratesetting context which the Appellants have not met, and have not even attempted to meet, in this case.

Clearly, utilities, like all other individuals and corporations, are protected from confiscatory government acts. *See, e.g, San Diego Gas & Electric Co. v. City of San Diego,* 450 U.S. 621 (1981). But in the ratemaking context, "[a]ll that is protected against, in a

constitutional sense," is that the overall rates allowed a utility not be set at a confiscatorily low level. *FPC v. Texaco, supra,* 417 U.S. at 391-92. It is entirely appropriate for this Court to limit constitutional review of rate orders to cases in which utilities can demonstrate that the overall result creates substantial harm to investor interests. Otherwise, this Court will once again find itself in the pre-*Hope* position of evaluating ratemaking methods as applied to individual items of utility property, in order to determine whether even minimal reductions in massive proposed rate increases are somehow confiscatory.

The investor interests described in *Hope* clearly pertain to the *overall* level of rates, not to the investment in any particular asset. While the OCA will argue below that the investor interests set forth in *Hope* need not be satisfied in every case, it is clear that these interests have not even been brought into issue by the relatively minor rate adjustments that are likely to result from the Pennsylvania Supreme Court decision in this case.

For this reason, the Appellants' reliance on the decision of the D.C. Circuit Court of Appeals in *Jersey Central Power & Light Co. v. FERC,* 810 F.2d 1168 (D.C. Cir. 1987) (en banc) is also misplaced. In that case, the utility appealed FERC's summary rejection of its request for a hearing on whether its claim for a partial return on abandoned power plant costs (or, alternatively, for a higher rate of return on its other assets) was appropriate under the *Hope* end result test. FERC denied the company a hearing, even though the company alleged that it was in financial distress and that the rate increase requested was "the minimum necessary to restore the financial integrity of the Company." 810 F.2d at 1178. Writing for the majority of a sharply divided court, Judge Bork stated that Jersey Central was entitled to a hearing on its *Hope*-related contentions at that stage of the proceeding. Judge Bork, however, carefully limited the scope of the Court's holding as follows:

> Under *Hope*, as we have stated repeatedly, the *only* circumstance under which there is a *possibility* of a taking of investors' property by virtue of rate regulation is when a utility is

> in the sort of financial difficulty described in Justice Douglas' opinion. If a utility is in that state, the Commission must inquire whether a reasonable return—on investment, not on facilities—has been afforded to investors, taking into account whether any higher return would amount to exploitation of consumers. Under those circumstances, it may be permissible or even proper to grant the utility a greater return on its prudent investments than it otherwise would have received. *But absent the sort of deep financial hardship described in Hope, there is no taking, and hence no obligation to compensate, just because a prudent investment has failed and produced no return.*

Id. at 1181 n.3 (emphasis added).

While the OCA will argue below that the used and useful principle may be applied even where the application of that principle results in financial distress to the utility, the point here is that the *Jersey Central* decision does not support, and indeed contradicts, the position taken by the Appellants in this case.

In the present case, the Appellants have not even alleged, let alone demonstrated, that they have met the requirements for raising a confiscation claim under *Hope*. Their constitutional appeal therefore can and should be rejected by this Court without any need to further address the merits of their specific arguments.

C. The Appellants' "Facial" Attack On The Used And Useful Principle Is Also Misplaced. It Is The Result Reached, Not The Method Employed, Which Is Controlling For The Purposes Of Determining Whether A Rate Order Can Be Challenged As Confiscatory.

In addition to failing to address the financial impact of the Pennsylvania Supreme Court Order on their overall operations, the Appellants have violated another cardinal principle established in *Hope* by focusing their challenge on the "used and useful" ratemaking methodology utilized in this case.

Hope did not mandate, nor did it prohibit, any particular ratemaking methodology. On the contrary, Justice Douglas noted in *Hope* that it is the "total effect of the rate order" which is controlling and that "[t]he fact that the method employed to reach that result may contain infirmities is not then important." 320 U.S. at 602.

Hope recognized that utility ratemaking is properly a legislative function within the police powers of the state. The Court thus firmly rejected the eminent domain theory upon which "fair value" ratemaking had been based. As stated by the Court:

> Rate-making is indeed but one species of price-fixing. *Munn v. Illinois*, 94 U.S. 113, 134. The fixing of prices, like other applications of the police power, may reduce the value of the property which is being regulated. But the fact that the value is reduced does not mean that the regulation is invalid.

320 U.S. at 601. *See* Hale, *Utility Regulation In The Light Of The Hope Natural Gas Case*, 44 COLUM. L. REV. 488, 488-96 (1944); Drobak, *From Turnpike To Nuclear Power: The Constitutional Limits On Utility Rate Regulation*, 65 B.U.L. REV. 65, 82-88 (1985).

The Appellants in this case recognize, as they must, that *Hope* represented "a major turning point in this Court's takings jurisprudence." Appellants' Brief at 14. Yet, the Appellants inexplicably go on to suggest that *Hope* merely "re-focus[sed] the inquiry from the 'fair value' of particular assets to a return *of* and *on* the shareholders' investment." *Id.* (emphasis in the original).

While *Hope* clearly rejected the concept that "fair value" ratemaking was constitutionally mandated, there is absolutely no support for the proposition that *Hope* replaced that standard with a new constitutional requirement that utility shareholders must receive a return of and a return on all of their investments. As one contemporary commentator characterized the holding in *Hope*:

> This disposition not only does away with reproduction cost, but also frees the Commission, or any regulatory body, from

> technical requirements in fixing reasonable rates. The end result is controlling regardless of the methods employed. No particular rate base provisions are imposed, provided that the rates as fixed are all-around "just and reasonable."

Bauer, *The Establishment And Administration Of A "Prudent Investment" Rate Base*, 53 YALE L.J. 495, 504 (1944). *See also* Drobak, *supra* at 85 n.87 ("The opinion in *Hope* even freed regulators from the constitutional requirement of using any rate base at all in setting rates.").

Subsequent to *Hope*, this Court consistently has refused to overturn rate orders or ratemaking schemes on the basis of the specific methods employed. This doctrine of judicial restraint survived its most stringent challenge in a series of cases decided by this Court which addressed the Federal Power Commission's efforts to regulate the rates of gas producers under the Natural Gas Act. In the wake of this Court's holding in *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954), that the FPC had jurisdiction over the rates charged by independent natural gas producers, the FPC was required to develop methods by which it could determine just and reasonable rates for thousands of such gas producers.

In the first decision addressing this issue, *Wisconsin v. FPC*, 373 U.S. 294, 298-99 (1963), the Court noted the FPC's "basic conclusion" that "the individual company cost-of-service method, based on theories of original cost and prudent investment, was not a workable or desirable method for determining the rates of independent producers." The Court also noted the FPC's proposed solution to this dilemma, *i.e.* the setting of "area rates" under which rates "would be established on an area basis, rather than on an individual company basis." *Id.* at 299.

In rejecting a preliminary challenge to this methodology, the Court, in an Opinion by Justice Harlan, reaffirmed the holding of *Hope* that "it is the result reached not the method employed which is controlling." *Id.* at 309. As stated by the Court:

> [T]o declare that a particular method of rate regulation is so sanctified as to make it highly unlikely that any other method could be sustained would be wholly out of keeping with this Court's consistent and clearly articulated approach to the question of the Commission's power to regulate rates.

Id.

This initial affirmation of area rates was subsequently upheld by the Court in Justice Harlan's seminal opinion in *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968). In *Permian Basin*, the Court held that there was "no constitutional infirmity" in the adoption of an area rate system for the gas produc[illegible]n the Permian Basin. Id. at 774. The Court thus approved a rate-setting process under which the specific costs of each producer were not examined.

Quite clearly, the Court found no constitutional problem in the fact that area rates might not permit some producers to recover a return of and a return on all of their prudent investments. Indeed, the primary reference to the specific costs of individual producers is found in Justice Harlan's discussion of the Commission's determination that it could permit "appropriate relief" in the event that an individual producer's "out-of-pocket expenses" exceed the producer's revenues under the area rates for a specific well. *Id.* at 770-71. While neither the Commission nor the Court identified what these "out-of-pocket" expenses included, *see id.* & n.35, they are referred to by Justice Harlan as "operating expenses." *Id.* at 771. With respect to other costs, Justice Harlan noted that the Commission emphasized that "a producer's inability to recover either its unsuccessful exploration costs or the full 12% return on its production investment would not, without more, warrant relief." *Id.*

Subsequently, in *FPC v. Texaco Inc.*, 417 U.S. 380 (1974), the Court, in an opinion by Justice White, rejected a facial attack on a proposed method for "indirect regulation" of small gas producers under the Natural Gas Act. Justice White noted that:

> Any broadside assertion that indirect regulation will

be confiscatory is premature. The consequences of indirect regulation can only be viewed in the entirety of the rate of return allowed on investment, and this effect will be unknown until the Commission has applied its scheme in individual cases over a period of time.

Id. at 392.

This principle was again confirmed in Justice Brennan's opinion for the Court in *Mobil Oil Corp. v. FPC*, 417 U.S. 283 (1974). That case involved an attack by various parties on the "area" rates established for gas producers in the Southern Louisiana area. As stated by Justice Brennan:

> Petitioner Mobil contends that the rates fixed for both flowing or first vintage gas and new or second vintage gas are too low. New York and MDG attack the rates for flowing gas as too high, but do not attack the new-gas rates. Each of the arguments is premised on a common error: that certain provisions of the order can be isolated and viewed without regard to the total effect the order is designed to achieve.

417 U.S. at 315. In responding to attacks on certain components of the area rates, Justice Brennan stated:

> Mobil's argument assumes that there is only one just and reasonable rate possible for each vintage of gas, and that this rate must be based entirely on some concept of cost plus a reasonable rate of return. We rejected this argument in *Permian Basin* and we reject it again here.

Id. at 316.

Finally, in *FERC v. Pennzoil Producing Co.*, 439 U.S. 508 (1979), the Court, per Justice White, criticized the Court of Appeals in that case for attempting to limit the discretion of the Federal Energy Regulatory Commission (FERC) in setting rates under the Natural Gas Act. While agreeing that the FERC Order regarding its ability to grant exceptions to area rate levels had to be remanded,

Justice White stated:

> We are also convinced, however, that the Court of Appeals trenched upon the ratemaking authority vested in the Commission when it strongly suggested that the Commission is required to grant the relief Producers request in this case so long as the increase in royalty costs is not imprudent and the relief, when granted, will merely sustain rather than increase Producers' profits.

Id. at 517. The Court thus flatly rejected the suggestion that a utility is entitled as a matter of constitutional law to recovery of all prudently incurred costs.

While the Appellants in the present case purport to be following the precepts of this Court set forth in *Hope* and *Permian Basin*, their facial attack on the used and useful principle can prevail only if this Court is willing to overrule the fundamental principles of judicial restraint set forth in those cases as well as in *Wisconsin, Texaco, Mobil Oil*, and *Pennzoil*. These cases uniformly stand for the proposition that no specific ratemaking method is either constitutionally required or constitutionally forbidden.

Accordingly, the Appellants' facial attack upon the used and useful ratemaking methodology must be rejected by this Court.

II. THE USED AND USEFUL STANDARD REMAINS A CONSTITUTIONALLY PERMISSIBLE RATEMAKING METHODOLOGY.

The thrust of the Appellants' attack on the used and useful principle is found at page 19 of their Brief where they state that: "The 'used and useful' test is inconsistent with the balancing of interests required by *Hope* and *Permian*." According to Appellants, the used and useful principle focuses only "on the consumer interest in receiv-

ing service at the lowest possible rate and not the range of other investor and consumer interests *in the investment at issue.*" *Id.* (emphasis added).

As with all the arguments in their Brief, the Appellants mistakenly assert here that their constitutionally protected interests in this proceeding lie in the recovery from ratepayers of the particular "investment at issue." For the reasons previously set forth in this Brief, the OCA submits that the Appellants' insistence on challenging the method employed in resolving a single item in the overall rate determination renders their appeal unsustainable under each of this Court's utility rate decisions beginning with the *Hope* case in 1944.

Nevertheless, to the extent that the Court reaches the substantive merits of the Appellants' arguments concerning the used and useful principle, the OCA submits that those arguments are also without merit. There is nothing unconstitutional or unwise about the used and useful principle either on its face or as applied in this case. The used and useful principle clearly remains constitutionally permissible under this Court's decisions in *Hope* and *Permian Basin*. Moreover, the used and useful principle is soundly based as a matter of regulatory and economic principle, and the ability of state and federal legislatures and commissions to utilize this ratemaking methodology should not be precluded by this Court.

Prior to the *Hope* decision, there was no question that a utility had no constitutional right to a return on its investment in property which was not used and useful in the service of ratepayers. Thus, in *Denver Union Stock Yard Co. v. United States*, 304 U.S. 470, 475 (1938), the Court held:

> As of right safeguarded by the due process clause of the Fifth Amendment, appellant is entitled to rates, not *per se* excessive and extortionate, sufficient to yield a reasonable rate of return upon the value of property used, at the time it is being used, to render the services. *But it is not entitled to have included any property not used and useful for that purpose.*

(citations omitted) (emphasis added).

Subsequently, the *Hope* decision recognized that it is the end result of a rate order — not the method employed in achieving that result — which determines whether a utility can challenge the order as confiscatory. In light of that ruling, it has been held that the application of the used and useful principle is not constitutionally *required* in all cases. *See Washington Gas Light Co. v. Baker*, 188 F.2d 11, 18-19 (D.C. Cir. 1950)(Bazelon, J.), *cert. denied*, 340 U.S. 952 (1951).

The question raised by Appellants in this proceeding, however, is whether the continued reliance on the used and useful principle is constitutionally *permissible* after *Hope*. The answer to that question is clearly yes. As noted by Judge Wald in one recent opinion of the United States Court of Appeals for the District of Columbia:

> Although methods for determining values of rate base items have evolved since *Smyth v. Ames*, the precept endures that an item may be included in a rate base only when it is "used and useful" in providing service. In other words, current rate payers should bear only legitimate costs of providing service to them.

Natural Gas Pipeline Co. of America v. FERC, 765 F.2d 1155, 1157 (D.C. Cir. 1985), *cert. denied*, 474 U.S. 1056 (1986), (*quoting Tennessee Gas Pipeline Co. v. FERC*, 606 F.2d 1094, 1109 (D.C. Cir. 1979), *cert. denied*, 445 U.S. 920 and 447 U.S. 922 (1980)). In another recent Opinion of that Court, Judge Starr noted that:

> For nearly a century the "used and useful" principle, enunciated by the Supreme Court in *Smyth v. Ames*, 169 U.S. 466, 18 S.Ct. 418, 42 L.Ed. 819 (1898), has stood as a bedrock principle of utility rate regulation. The principle is simple— it requires that costs associated with electric power plants be paid by the ratepayers who benefit from the plant.

Kentucky Utilities Co. v. FERC, 760 F. 2d 1321, 1324 n.4 (D.C. Cir. 1985).[3]

It is not without reason that the used and useful principle has stood for a century as the predominant method for establishing the rate base on which utility rates are set. As a matter of common sense and economic fairness, it is appropriate to charge ratepayers only for the costs of utility facilities that provide service to them. While there is substantial variation among the numerous statutory and regulatory schemes in the application of the used and useful principle, the fundamental theme of most state and federal ratemaking methodologies is that ratepayers may only be required to pay the costs of the facilities that serve them.

Moreover, there is nothing "inconsistent" between the application of the used and useful principle and theconsideration of the investor interests identified by the Court in *Hope*. In most cases — and indeed the present case provides a perfect example — the allowance of a return of and on a utility's used and useful investments is sufficient to satisfy the investor interests identified in Hope. The fact that the utility receives no *additional* compensation for non-used *and useful investments is therefore of no constitutional moment under Hope*.

[3]The Brief of Amicus Curiae Edison Electric Institute (EEI) questions not only the wisdom, but also the heritage, of the used and useful principle. At page 11, note 12, EEI observes that this Court's Opinion in *Smyth v. Ames*, 169 U.S. 466 (1898) did not actually employ the term "used and useful". Rather, EEI suggests, "somewhere along the way that apparently catchy phrase was substituted for the actual phrase employed by the Court." The OCA would note in response that one of the first of this Court's Justices to employ this "catchy phrase" was Justice Holmes in his 1903 Opinion for the Court in *San Diego Land and Town Co. v. Jasper*, 189 U.S. 439 (1903). That case involved a utility which developed excess capacity that was not needed by current customers. Rather than require existing customers to bear the full cost of that excess capacity, Justice Holmes wrote, "we should assume that only a proportionate part of the system was actually used and useful within the meaning of the statute." *Id.* at 447.

Even where the allowance of a return only on used and useful property does harm investors, however, the recognition of such an adverse impact is only the beginning, and not the end of the applicable constitutional analysis. The *Hope* decision essentially established a two-step review when a utility challenges the constitutionality of a rate order. *First*, the Court will ascertain whether the end result of the rate order produces substantial harm to investor interests. If the rate allowance permits the utility to operate successfully and to attract capital, the utility cannot claim confiscation, and constitutional review of the rate order is at an end. *Second*, if and only if the rate order results in substantial harm to investors, the Court will then examine whether such harm is justified by countervailing public policy or consumer interests.

Thus, while the Court in *Hope* recognized the investor's "legitimate concern with the financial integrity of the company," 320 U.S. at 603, the Court *prefaced* that remark by quoting the statement in its earlier opinion in *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 590 (1942), that "regulation does not insure that the business shall produce net revenues." 320 U.S. at 603. Because the appeal in *Hope* concerned only whether the *investor* interests had been adequately considered, and because the Court concluded that the "end result" in that case could not be condemned "as unjust and unreasonable *from the investor or company viewpoint*," *id.* (emphasis added), it was not necessary for the Court to set forth in detail the countervailing ratepayer interests which also must be considered. The Court thus noted that "[t]he conditions under which more or less might be allowed are not important here." *Id.*

Subsequent decisions of this Court have confirmed that there are indeed a number of instances in which "less might be allowed" than is necessary to satisfy the investor interests described in *Hope*. For example, just one year after *Hope*, the Court, in an Opinion by Justice Jackson, unanimously ruled in *Market Street Railway Co. v. Railroad Commission*, 324 U.S. 548, 567 (1945), that the reduced rates set for a failing street railway company were not confiscatory and that the company had no constitutional right to demand a return

on the value of investment "after it has vanished, even if once prudently made." In response to the company's claim that the rate order was "confiscatory by the tests of *Federal Power Commission v. Hope Natural Gas Co.*," because it did not insure the financial integrity of the enterprise, Justice Jackson responded:

> It was noted in the *Hope Natural Gas* case that regulation does not assure that the regulated business make a profit. 320 U.S. at 603; see *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575, 590. *All that was held* was that a company could not complain if the return which was allowed made it possible for the company to operate successfully.

324 U.S. at 566 (emphasis added).

Subsequently, in *Permian Basin, supra,* the Court upheld, as a matter of administrative necessity, a ratesetting procedure which was based on the *average* costs of a large number of natural gas producers and did not specifically address the investor interests in the return of or on the capital costs of individual producers. The Court in *Permian Basin* noted that, while the investor interests set forth in *Hope* remain "pertinent", they "scarcely exhaust the relevant considerations." 390 U.S. at 791.

The OCA submits that another instance in which "less might be allowed" than is necessary to satisfy investor interests is one in which a substantial portion of a utility's investments are not used and useful to ratepayers. As stated by the Pennsylvania Supreme Court in a prior decision which was unsuccessfully appealed to this Court:

> The "used and useful" principle is soundly based, for it serves to protect consumers from exploitation, and it comports with the view that, in fairness, consumers should not be required to buoy up failing utility companies by being required to, in effect, provide public subsidies for utility properties that are not useful in the public service. If the *Hope* decision were to be interpreted as providing constitutional guarantees for the achievement of investor interests, the "used and useful" principle would have to yield, at least in exceptional situations where the financial integrity of a utility is imperiled, but we do not perceive from *Hope* that investor interests are to be accorded such a guaranteed status.

Pennsylvania Electric Co. v. Pennsylvania Public Utility Commission, 509 Pa. 324, 333-34, 502 A.2d 130, 135 (1985), *appeal dismissed sub nom. Metropolitan Edison Co. v. Pennsylvania Public Utility Commission,* 476 U.S. 1137 (1986). The utilities' appeal of that decision to this Court was dismissed for lack of a substantial federal question.

While the used and useful principle typically is applied to cases involving the "rate base", or the investment *on* which the utility may charge a return, it can also be applied to questions involving the return *of* capital in investments which do not serve ratepayers. Thus, for example, in the recent D.C. Circuit *Natural Gas Pipeline* case noted above, the Court upheld the Federal Energy Regulatory Commission's denial of the recovery *of* the pipeline company's investment in three unsuccessful gas supply projects. 765 F.2d at 1156. Even though the company did not seek to earn a return *on* this investment, the Court affirmed FERC's denial of recovery of the costs, based on FERC's rationale that "the expenditures were not used and useful to ratepayers." *Id.* at 1158.

Similarly, in the present case, the Pennsylvania Supreme Court recognized that the utilities could not recover their investments in non-used and useful facilities simply by "converting them into operating expenses through amortization." 532 A.2d at 332. (App. 15a). This interpretation is, of course, consistent with the express language of the section of the Pennsylvania Public Utility Code at issue, which states that the costs of non-used and useful facilities "shall not be made a part of the rate base nor otherwise included in the rates charged by the electric utility."

While a number of regulatory jurisdictions have determined, as a matter of ratemaking *policy*, that the costs of abandoned plants may be recovered from ratepayers, utilities have no *constitutional* right to a return *on or* a return *of* investment in plant which is not used and useful to ratepayers.[4]

In summary, the OCA submits that the used and useful principle remains constitutionally permissible after *Hope*. In the present case, the application of the used and useful principle does not even call into question the investor interests which are considered under *Hope*. Even where these investor interests do clash with the used and useful principle, however, *Hope* does not require that the investor interests be satisfied in all cases.

Hope recognized that regulation does not insure that a utility will produce net revenues. 320 U.S. at 603. One instance in which it is possible that net revenues need not be insured by the ratepayers is where the utility's investments, for whatever reason, fail to provide used and useful service to those ratepayers.

[4]Appellants suggest at page 30-31 of their Brief that the Court in *Hope* drew a constitutional distinction between the return *on* investment and the return *of* investment through depreciation. 320 U.S. at 606. This interpretation of *Hope* is incorrect and is indeed contrary to the fundamental holdings of that case. The Court in that section of the *Hope* decision merely rejected the company's argument that the FPC had erred by establishing the depreciation allowance on the basis of original cost, and found that "[n]o more is required." *Id.* The Court certainly did not suggest that the utility could recover depreciation on non-used and useful investment. Indeed, the Court referenced a provision of the Natural Gas Act which permitted the FPC to establish depreciation rates for "the several classes of property of each natural-gas company *used or useful* in the production, transportation, or sale of natural gas." *Id.* at 606 n.12 (emphasis added).

III. THE PENNSYLVANIA GENERAL ASSEMBLY IS NOT BARRED FROM REQUIRING THE PENNSYLVANIA PUBLIC UTILITY COMMISSION TO EXCLUDE THE COSTS OF CERTAIN NON-USED AND USEFUL INVESTMENTS IN SETTING JUST AND REASONABLE RATES.

In addition to questioning the general wisdom and constitutionality of the used and useful principle, the Appellants contend that it is particularly inappropriate to apply such a principle as a matter of law. Such a *per se* application of this principle, according to Appellants, "unconstitutionally precludes the PUC from considering factors pertinent to the balance between investor and consumer interests." Appellants' Brief at 23. Relying primarily on Justice Harlan's discussion of judicial review in *Permian Basin*, 390 U.S. at 790-92, the Appellants contend that, under the Pennsylvania Supreme Court's interpretation of the statute at issue here, the PUC

> is constrained to produce a rate order that does not reflect a balance of investor and consumer interests *with respect to the Duquesne and Penn Power investment in the four CAPCO units.*

Appellants' Brief at 25-26 (emphasis added).

Once again, the Appellants misconstrue *Hope* and *Permian Basin* when they suggest that their constitutionally protected interests are in particular investments. In fact, as a review of the rate orders at issue plainly demonstrates, the recovery of the costs at issue here was only one of a large number of issues that produced the overall rate levels authorized in this case. *See* Appellants' Appendix C and E.

The challenged legislation affects only a part of the Commission's overall determination of just and reasonable rates. Indeed, the "just and reasonable" standard, which Appellants claim is violated by the Pennsylvania ratemaking scheme, remains the fun-

damental overriding element of all ratemaking determinations in Pennsylvania under both statutory and case law. 66 Pa. Cons. Stat. §1301 (1987); *Pennsylvania Public Utility Commission v. Pennsylvania Gas and Water Co.*, 492 Pa. 326, 337, 424 A.2d 1213, 1219 (1980), *cert. denied*, 454 U.S. 824 (1981).

Moreover, the OCA submits that Appellants seriously misconstrue this Court's *Permian Basin* holding, as well as the entire theory of legislative delegation, when they suggest that the Pennsylvania ratemaking scheme is constitutionally deficient because it is too specific. *Permian Basin* does not hold that the overall authority of a commission to set just and reasonable rates cannot be circumscribed by the legislative body from which the commission's powers are derived. Rather, Justice Harlan noted in that case that the commission

> must be free, *within the limitations imposed by pertinent constitutional and statutory commands*, to devise methods of regulation capable of equitably reconciling diverse and conflicting interests.

390 U.S. at 767 (emphasis added). Justice Harlan added that

> rate-making agencies are not bound to the service of any single regulatory formula; they are permitted, *unless their statutory authority otherwise plainly indicates*, "to make the pragmatic adjustments which may be called for by particular circumstances."

Id. at 776-77 (citation omitted) (emphasis added).

Certainly, Justice Harlan did not suggest that Congress *could not* have enacted more specific standards in the Natural Gas Act than the just and reasonable standard. Rather, he recognized that Congress *did not* enact such standards. He therefore set forth the considerations which the FPC was required to address in order to permit proper judicial review of its orders under the broad just and

reasonable standard. *Id.* at 790-92.

This interpretation of the relative standing of the legislature and its designated administrative arm is consistent with the discussion of this issue by Justice Douglas in an opinion which he authored for the Court shortly after the Hope decision. In *Colorado Interstate Gas Co. v. FPC*, 324 U.S. 581 (1945), Justice Douglas upheld an FPC cost allocation methodology, and noted that:

> When Congress, as here, fails to provide a formula for the Commission to follow, courts are not warranted in rejecting the one which the Commission employs unless it plainly contravenes the statutory scheme of regulation. *If Congress had prescribed a formula it would be the duty of the Commission to follow it.*

324 U.S. at 589 (emphasis added).

In the Natural Gas Act, Congress established the statutory standard of just and reasonable rates and thus left the Federal Power Commission with substantial discretion in setting those rates. In Pennsylvania, the General Assembly has also established the overriding requirement that rates must be just and reasonable, 66 Pa. Cons. Stat. §1301 (1987), but has "plainly indicated" to the Public Utility Commission that in setting such rates, the Commission must exclude recovery of costs of certain non-used and useful assets. 66 Pa. Cons. Stat. §1315 (1987).

Under the Appellants' apparent view of public utility regulation, the ratemaking chapters of the public utility codes of each of the 50 states would be allowed to consist of only one sentence: "Rates must be just and reasonable." Like many state legislatures, however, the Pennsylvania General Assembly has not chosen to issue a one-sentence long Public Utility Code. Rather, the General Assembly has gone on to provide specific substantive and procedural directives which must be followed by the Public Utility Commission in setting just and reasonable rates. These provisions do not attempt to repeal the overriding statutory and constitutional requirement that overall

rate levels must be just and reasonable; rather, they provide specific instructions on how certain sub-issues must be addressed in making that ultimate rate determination. While the General Assembly theoretically could have granted its administrative ratemaking arm absolute discretion in setting rates under the just and reasonable standard, it has chosen not to do so. There is certainly nothing constitutionally defective about this choice, particularly since the Pennsylvania Public Utility Code retains the just and reasonable standard as its overriding rate requirement.

Indeed, it would be a curious ruling for this Court to hold that, as a matter of constitutional law, an administrative agency must have broader discretion than the legislative body which creates it. Public utility commissions are nothing more than administrative arms of the state legislatures which create them. As stated by the Pennsylvania Supreme Court in the present case:

> It is clear, beyond any need for citation, that the function of ratemaking for public utilities is legislative in nature. The Commission is but an instrumentality of the state legislature for the performance of that function; and the agency has only such powers as are expressly conferred upon it by statute or exist by necessary implication.

532 A.2d at 339. (App. 30a). *See also Minnesota Rate Cases*, 230 U.S. 352, 433 (1913) ("The rate-making power is a legislative power and necessarily implies a range of legislative discretion. We do not sit as a board of revision to substitute our judgment for that of the legislature, or of the commission lawfully constituted by it, as to matters within the province of either.")[3]

[3]Indeed, for a great part of this Court's history, the issue of constitutional concern was the exact opposite of the one raised by Appellants here. That is, challenges to state and federal laws were raised on the ground that the legislatures had delegated too *much* authority and discretion to administrative agencies. This Court held, however, that:

> If Congress shall lay down by legislative act an intelligible principle to which the person or body authorized to fix such rates is directed to conform, such legislative action is not a forbidden delegation of legislative power.

J.W. Hampton, Jr. & Co. v. United States, 276 U.S. 394, 409 (1928).

Since the state legislatures could (and, in many cases, once did) set rates in their jurisdictions themselves, it is certainly within their powers to provide specific statutory directions to the commissions they have created to carry out those duties. Unless such specific legislative directions necessarily preclude the setting of just and reasonable rates on an overall basis, they cannot be found, in and of themselves, to be unconstitutional.

Again, when the Appellants claim that Section 1315 precludes the Commission "from balancing investor and consumer interests when considering a utility's investment in cancelled electric generating units," Brief at 24, they misstate the entire premise of constitutional review of ratemaking determinations since *Hope*. The duly elected General Assembly of Pennsylvania has prescribed the ratemaking treatment for this one issue as a matter of state public policy. The *constitutional* question is whether such a provision necessarily results in confiscatory overall rates. For the reasons set forth above, the OCA submits that it does not.

Similarly, the Appellants' argument that the PUC Orders below "reflect a balancing of investor and consumer interests," Brief at 20-23, is not of any constitutional significance. Even if true, the argument fails for the reasons set forth by Justice Brennan in *Mobil Oil, supra*, 417 U.S. at 316. Like Mobil Oil in that case, the Appellants here seem to assume "that there is only one just and reasonable rate." Here, one aspect of the original rate order has been found by the Pennsylvania Supreme Court to be erroneous as a matter of Pennsylvania state law, and the matter has been remanded to the PUC for further proceedings consistent with that finding. The correction of that error need not jeopardize the investor interests identified by the Court in *Hope*. *See* Section IB, *supra*. Even if it did, however, such a determination would not necessarily be impermissible in light of the public policy considerations embodied in the General Assembly's action.

Finally, the Appellants' argument at page 24, note 20, that the challenged legislation violates substantive due process standards is wholly without merit. The basis for the Appellants' argument on this

point appears to be the fact that the Pennsylvania Public Utility Code was amended in 1985 to permit recovery of certain costs incurred on power plants cancelled after the effective date of that amendment. The Appellants claim that the "interplay" between the provision here at issue and the amended legislation is "arbitrary and irrational" and thus violative of the Due Process Clause of the Fourteenth Amendment. In essence, the Appellants are arguing that it is unconstitutional for the state legislature to change a law.

The OCA submits that Section 1315 of the Public Utility Code obviously passes the standards for review of economic legislation established by this Court in *Nebbia v. New York*, 291 U.S. 502 (1934) and consistently observed by the Court since that time. *See, e.g., Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 729 (1984); *Schweiker v. Wilson*, 450 U.S. 221, 230 (1981); *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 15 (1976); *Ferguson v. Skrupa*, 372 U.S. 726, 730-31 (1963); *Williamson v. Lee Optical, Inc.*, 348 U.S. 483, 487-488 (1955). As stated by the Court in *Nebbia*:

> Price control, like any other form of regulation, is unconstitutional only if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt, and hence an unnecessary and unwarranted interference with individual liberty.

291 U.S. at 539.

Section 1315 of the Public Utility Code clearly embodied a legislative policy determination that ratepayers should not be required to bear the costs of certain useless utility investments. As noted by the Pennsylvania Supreme Court in this case, this legislation essentially codified long-standing principles of Pennsylvania public utility law. 532 A.2d 325, 338 (App. 29a). The policy behind that legislation, *i.e.* the used and useful principle, has been held by the Pennsylvania Supreme Court to be "soundly based, for it serves to protect consumers from exploitation." *Pennsylvania Electric*

Co., supra, 509 Pa. at 333, 502 A.2d at 135.[6]

While a strict application of the used and useful principle has a sound basis, however, it is not constitutionally required in all cases. Thus, the Pennsylvania Supreme Court in the present case ruled that, under Pennsylvania law,

> it should be clear that no utility of any type is permitted, *without express and valid legislative authorization*, to charge ratepayers for property which is not used and useful in the production of current utility service.

532 A.2d 338 (App. 28a-29a) (emphasis added). Section 520, the 1985 amendment to the Public Utility Code which is addressed by Appellants in their Brief, was an express legislative exception to the strict application of the used and useful principle which had been codified in Section 1315.

The OCA submits that Sections 1315 and 520 represent two policy determinations by the Pennsylvania General Assembly. Both views are constitutionally permissible and both can be applied consistently with the overriding requirement of Section 1301 of the Pennsylvania Public Utility Code that all rates must be just and reasonable. The statutory change which gave rise to these different results was neither arbitrary nor irrational, but rather illustrates the proper exercise of public policy determinations by a state legislature. In considering the public interest, as well as the interests of ratepayers and investors, the General Assembly determined that it was appropriate to create a prospective exception in Section 520 to the general rule of Section 1315 against the inclusion in rates of the costs of non-used and useful investment.

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[6]This Court recently rejected a due process clause challenge to a rent control law in *Pennell v. City of San Jose*, 108 S.Ct. 849, 857-58 (1988). After citing the standards for review of economic regulation set forth in *Nebbia* and *Permian Basin*, the Court, in the Opinion by Chief Justice Rehnquist, noted that "we have long recognized that a legitimate and rational goal of price or rate regulation is the protection of consumer welfare." *Id.* at 858.

Neither Section 1315 nor the "interplay" between Sections 1315 and 520 is arbitrary or irrational. On the contrary, these provisions represent the type of legislative policymaking which states must be free to perform and which this Court has refused to disturb for the last 50 years. It would be extraordinary, to say the least, if this Court were to hold that changes in legislative policies are inherently unconstitutional. The Appellants' due process claim is without merit and must be rejected by this Court.

IV. THE DENIAL OF RECOVERY OF THE COSTS AT ISSUE HERE DID NOT EFFECT A "TAKING" OF THE APPELLANTS' PROPERTY.

Appellants' final argument, at pages 26-33 of their Brief, is that the challenged legislation, as interpreted by the Pennsylvania Supreme Court in this case, is *per se* unconstitutional because it "frustrates the reasonable expectations of utility investors and prevents them from being compensated for their prudent investment dedicated to public use." Brief at 26.

The Appellants thus appear to base their last argument on this Court's traditional "takings" jurisprudence and, in particular, the question of whether governmental conduct unduly interferes with "reasonable investment-backed expectations." Brief at 27, *citing Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1975).

Before addressing the merits of the Appellants' confiscation claim, it is necessary to ask: what has been "taken" in this case and by whom?

The Appellants continually assert that their investments in the four cancelled plants have been taken as a result of the order in this case. Yet, there is no dispute that the Appellants, and their Ohio utility partners, voluntarily cancelled these projects and *then* came to their respective public utility commissions for recovery of costs of these now worthless investments.

No government action was responsible for the total elimination of the value of these investments. It is therefore not at all clear why the government — or, more precisely, the ratepayers of these ...ities through the regulatory action of the PUC — must "compensate" the utilities for the lost value.

These investments are thus comparable to the assets in *Market Street Railway, supra*, whose value had "vanished." 324 U.S. at 567. As noted by Justice Jackson in that decision, while the due process clause has been applied "to prevent governmental destruction of existing economic values," it cannot be used "to restore values that have been lost by the operation of economic forces." *Id.*

The issue of when a "taking" occurs in the utility ratemaking context was addressed by Judge Starr in his concurring opinion in *Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168, 1189-94 (D.C. Cir. 1987). *See also*, Drobak, *supra*, at 98-112. As noted by Judge Starr:

> [A] taking does not occur when financial resources are committed to the enterprise. That is especially so since a utility's capital investment is made not simply in satisfaction of legal obligations to provide service to the public but in anticipation of profits on the investment. The utility is not a servant to the state; it is a for-profit enterprise which incurs legal obligations in exchange for state-conferred benefits.

810 F.2d at 1189.

In the present case, Appellants argue that they incurred these investment costs pursuant to their statutory obligation to provide service to their ratepayers. They fail to note, however, that this obligation to serve is the *quid pro quo* for the utilities' monopoly franchise to provide electric service to those customers. Moreover, they fail to acknowledge that a general obligation to serve does not specify how those obligations are to be met at any given time. As stated by Judge Starr:

> [G]overnment forced upon the utility an obligation to provide service, but that obligation, as we have seen, is the *quid pro quo* for a protected area of service (and eminent domain authority). What is fundamental is that government did not force upon the utility a specific course of action for achieving the mandated goal.

Id. at 1190.

Certainly, Judge Starr's description of the regulatory process is applicable here. Duquesne and Penn Power do in fact have an obligation to serve their customers, but they also have monopoly franchises which prohibit any other parties from providing retail electric service in their respective service territories. Moreover, these companies can meet their service obligations in any number of ways — including the construction of new capacity of all sizes and fuel types, the purchase of power from neighboring utilities, the purchase of power from independent cogenerators and small power producers, or the implementation of conservation and load management programs. Suffice it to say that Duquesne and Penn Power were never ordered by any governmental authority to start construction on these four plants, and they were never ordered to cancel them.

Turning to the specific analysis of the Appellants' confiscation claim, this Court's jurisprudence teaches us that a takings claim will be examined through "essentially ad hoc, factual inquiries" which address such factors as 1) the economic impact of the regulation; 2) the nature of the government action; and 3) the extent to which the regulation has interfered with investor-backed expectations. *Penn Central Transportation Co. v. New York City*, 438 U.S. 104, 124 (1978); *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 432 (1982). For example, the Court has held that a taking "may more readily be found when the interference with property can be characterized as a physical invasion by government", *Penn Central, supra,* at 124, whereas, the "loss of future profits—unaccompanied by any physical property restriction—provides a slender reed upon which to rest a takings claim." *Andrus v. Allard*, 444 U.S. 51, 66 (1979).

First, with respect to the economic impact of the Order under appeal, the OCA has previously noted the relatively minor nature of the disallowance here at issue. *See* Section IB, *supra*. This factor is particularly important in the ratemaking context because the initial test for confiscation revolves around overall rates, not the specific items comprising those rates. This view is also consistent with this Court's other takings cases, which compare the value of what is allegedly taken to the value of the *entire* property at issue. *See Penn Central, supra,* 438 U.S. at 131 ("'Taking' jurisprudence does not divide a single parcel into discrete segments and attempt to determine whether rights in a particular segment have been entirely abrogated."); *Keystone Bituminous Coal Association v. DeBenedictis,* 107 S.Ct. 1232, 1248 (1987) (citation omitted) ("Because our test for regulatory taking requires us to compare the value that has been taken from the property with the value that remains in the property, one of the critical questions is determining how to define the unit of property 'whose value is to furnish the denominator of the fraction.'")

In the present Duquesne case, for example, if one views the "denominator" as the Company's total allowable revenues of over $800 million per year (App. 126c), the approximate $3.4 million reduction in those revenues which would result from the disallowance represents less than one half of one percent of the total. The percentage for Penn Power is comparable. Moreover, neither Appellant has alleged that this disallowance will have a significant negative impact on their overall rates or financial condition.

With respect to the second prong of this Court's takings analysis, the nature of the government action here could hardly be less intrusive. The utilities came to the government (in the form of the Pennsylvania Public Utility Commission) and asked for compensation for an investment rendered worthless by the utilities' own voluntary actions. There was certainly no physical intrusion and the Appellants weren't ordered to do anything.

Finally, with respect to investor-backed expectations, the OCA submits that if investors expected recovery of these specific

costs, they had no basis for such expectations under either Pennsylvania or federal law.

Thus, while Appellants state that "[t]he reasonable expectations of utility investors requires recovery, *per se*, of a utility's prudent investment in cancelled electric generating units," Brief at 26, the Appellants fail to cite a single Pennsylvania case or statute which would have given rise to such expectations. Quite to the contrary, the Pennsylvania Supreme Court Order, which is authoritative with respect to matters of state law, (*see Brinkerhoff-Faris Trust & Savings Co. v. Hill*, 281 U.S. 673, 680-81 (1930); *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 160 (1980)), specifically noted that the used and useful principle is one of the "cardinal principles of this state's public utility law," citing cases dating back to 1921 and 1924, 532 A.2d at 334-335 (App. 19a-20a). The Court further held that:

> Given what we have already said about the fundamental principles of this state's public-utility jurisprudence, it should be clear that no utility of any type is permitted, without express and valid legislative authorization, to charge ratepayers for property which is not used and useful in the production of current utility service.

532 A.2d at 338 (App. 28a-29a). Certainly, the Appellants have cited no express legislative authorization for recovery of the costs at issue here.

Similarly, while the Appellants might prefer to see the "prudent investment" standard established as the constitutionally required law of the land, the D.C. Circuit Court of Appeals has correctly noted that "the 'prudent investment' approach has *never* been adopted by the Supreme Court as the sole method of rate base determination." *Communications Satellite Corp. v. FCC*, 611 F.2d 883, 890 (D.C. Cir. 1977) (emphasis in the original).

This Court has recognized that investor expectations based on inaccurate interpretations of the law are not protected by the takings

clause. *See Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1005-10 (1984); *Webb's Fabulous Pharmacies, Inc., supra*, 449 U.S. at 161 ("[A] mere unilateral expectation or an abstract need is not a property interest entitled to protection.") *See also* Drobak, *supra*, at 108 (footnote omitted) ("[E]ven if utility investors incorrectly perceive that the Constitution entitles them to profits that fulfill the investor interest of *Hope*, the Supreme Court would find that expectation to be unreasonable and therefore unprotected by the takings clause.")

The Appellants' confiscation claim in this case thus satisfies none of the standards for establishing an unconstitutional taking and should therefore be rejected.

V. THE COURT SHOULD REJECT THE ARGUMENTS OF THE APPELLANTS AND THE AMICI CURIAE THAT THE "PRUDENT INVESTMENT" TEST EITHER HAS BEEN OR SHOULD BE ADOPTED AS THE SOLE CONSTITUTIONALLY PERMISSIBLE RATEMAKING STANDARD.

While the Appellants suggest that utility investors have a constitutionally protected interest in recovery of all prudent investment, *see* Brief at 26-27, they stop short of suggesting that investors must also be guaranteed a return on that investment as well. *See* Brief at 27, note 21. The Brief of Pennsylvania Electric Association (PEA), as Amicus Curiae in support of Appellants, however, is not so restrictive in its approach.

PEA argues that the Court should adopt as the sole constitutional benchmark for utility ratemaking decisions a "prudent investment" standard which PEA attributes to Justice Brandeis in his concurring opinion in *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U.S. 276, 289-312 (1923). The OCA submits that the PEA has misinterpreted the import of Justice Brandeis' *Southwestern Bell* concurrence as well as the manner in which the *Hope* decision relied upon that concurrence. PEA's proposed standard has been consistently rejected in the past and should be rejected by the Court in this case. As set forth below, it

is OCA's position that this Court should not adopt the prudent investment standard — or for that matter, any single standard — as the sole constitutionally permissible ratemaking methodology.

When Justice Brandeis set forth his "prudent investment" standard in *Southwestern Bell*, he was writing in opposition to the "fair value" standard of ratemaking in which the courts had insisted that utility investors had a constitutional right to earn a fair return on the "fair value" of their utility investments. The fair value requirement was based on an eminent domain theory of ratemaking and required that utility investors be compensated — as in an eminent domain proceeding — for the current value, not simply the original cost, of their utility investments.

What Justice Brandeis, and a number of contemporary commentators recognized, was that the fair value standard was hopelessly circular, in that the "value" of utility property was determined by the rates allowed to support the property, and yet the rates were purportedly being set on the basis of that value. Moreover, methods of determining fair value, through such means as ascertaining the "reproduction cost" of recreating all the utilities' existing facilities at current prices, were highly unstable and difficult, if not impossible to verify in a meaningful manner. *See Southwestern Bell*, 262 U.S. at 292-298; Hale, *Utility Valuation: Does The Ghost Of Smyth v. Ames Still Walk?*, 55 HARV. L. REV. 1116 (1942); Bonbright, *The Problem Of Valuation: The Economic Merits Of Original Cost And Reproduction Cost*, 41 HARV. L. REV. 593 (1928).

Justice Brandeis argued that it was not the fair value of specific utility investments that was properly at issue, but rather the capital prudently invested in those facilities by the owners of the utilities.

OCA submits, however, that Justice Brandeis' prudent investment standard was *not* intended to stand *in opposition to* the used and useful principle. Rather, Justice Brandeis and other critics of fair value were concerned with the method of *valuation* used to determine the rate base on which investors could earn a return. It is a

mistake to assume that Justice Brandeis' prudent investment rule was intended to apply to everything in which a utility invested, without regard to whether or not that investment was used to provide utility service. Thus, for example, Justice Brandeis noted in the Southwestern Bell concurrence that "*so long as the specific items of property are employed by the utility*, their exchange value is not of legal significance." 262 U.S. at 290 (emphasis added). Moreover, in a footnote to his concurrence, Justice Brandeis equated "prudent investment" with "historical cost", which he defined as follows:

> Historical cost, on the other hand, is the amount which normally should have been paid for all the property *which is usefully devoted to the public service*. It is, in effect, what is termed the prudent investment.

262 U.S. at 295 n.6 (emphasis added). Justice Brandeis contrasted this definition of prudent investment with "actual cost" under which "there is no attempt to determine whether the expenditure was wise or foolish, *or whether it was useful or wasteful.*" *Id.* (emphasis added).[7]

Far from condemning the used and useful principle, therefore, the prudent investment theory as articulated by Justice Brandeis would appear to incorporate that principle as an appropriate element. Certainly, there is nothing in Justice Brandeis' concurrence which suggests that he believed utility investors had a constitutionally protected right to a return of or on investment in property which was not "usefully devoted to the public service."

More importantly, what this Court subsequently adopted in the *Hope* decision was not Justice Brandeis' "prudent investment" standard *per se*, but rather the rejection of the "fair value" standard which Justice Brandeis had so eloquently challenged. In rejecting

[7]Another proponent of the prudent investment standard defined his proposed "prudent investment" rate base as "the original cost of the properties used in public service, less the part of such cost which is applicable to past use." *Bauer, supra*, at 506.

fair value, however, the *Hope* case adopted no single constitutional standard to replace it. Indeed, *Hope* rejected the entire eminent domain analogy and recognized that ratemaking was an exercise of the police power which could, if necessary, "reduce the value of the property which is being regulated." 320 U.S. at 601. *See* Drobak, *supra*, at 85 n.87 ("The Court [in *Hope*] did not choose the prudent investment standard over reproduction cost. Rather, it left the regulatory commissions the option of choosing whatever methodology they preferred, so long as the constitutional test of *Hope* was satisfied.")

To the extent that utilities have argued in subsequent cases that the "prudent investment" test has or should replace the used and useful principle as a matter of constitutional law, this argument has been rejected. *See, e.g., Communications Satellite Corp.v. FCC*, 611 F.2d 883, 890 (1977); *NEPCO Municipal Rate Committee v. FERC*, 668 F.2d 1327, 1333 (D.C. Cir. 1981), *cert. denied*, 457 U.S. 1117 (1982); *Democratic Central Committee v. Washington Metropolitan Area Transit Commission*, 485 F.2d 786, 801 (D.C. Cir. 1973), *cert denied sub nom. D.C. Transit System, Inc. v. Democratic Central Committee*, 415 U.S. 935 (1974).

Amicus PEA cites no cases which have held that utilities have a constitutional right to a return of and on all expenditures that are not found to be imprudent. In contrast, OCA submits that numerous state and federal regulatory commissions and courts have recognized the continuing validity of the used and useful principle as a constitutionally permissible and economically sound ratemaking method.[8]

[8]In addition to the Pennsylvania Supreme Court and D.C. Circuit Court decisions noted above, *see, e.g., Dayton Power & Light Co. v. Public Utilities Commission*, 4 Ohio St.3d 91, 447 N.E.2d 733, 743 (Ohio 1983); *Citizens Action Coalition, Inc. v. Northern Indiana Public Service Co.*, 485 N.E.2d 610, 614-15 (Ind. 1985), *appeal dismissed and cert. denied*, 476 U.S. 1137 (1986); *Iowa-Illinois Gas and Electric Co. v. Iowa State Commerce Commission*, 412 N.W. 2d 600, 605 (Iowa 1987); *Lone Star Gas Co. v. Oklahoma*, 745 P.2d 723, 729 (Okla.

(Footnote continued on following page)

The OCA submits that one reason that the used and useful principle has continued to stand as the primary ratemaking principle in so many jurisdictions is that, as a practical matter, it makes sense.

It is well and good to pronounce that utilities must be allowed to earn a return of and on all of their "prudent investment," but the question cries out to be answered in the context of a rate proceeding: *prudent investment in what?*

If a utility makes an investment in a project of an unregulated subsidiary, should ratepayers be forced — as a matter of constitutional law — to pay a return of or on suchan investment? No, that investment is not used and useful to those ratepayers.

If Penn Power's parent company, Ohio Edison, makes an investment in a plant to serve Ohio ratepayers, must Penn Power ratepayers pay for it? No, it is not used and useful to Penn Power ratepayers.

What if Penn Power makes an investment to serve its wholesale customers, which are served under its Federal Energy Regulatory Commission jurisdiction? The used and useful principle assures that the ratepayers of each jurisdiction bear only the costs for which they are responsible.

And finally, what if a utility makes an investment which fails to provide service to anyone? The used and useful principle protects ratepayers from paying for this investment in *addition* to the investments which do provide service.

(Footnote continued from previous page)

1986); *Re Public Service Co.*, 125 N.H. 46, 480 A.2d 20, 23-24 (N.H. 1984); *Senior Citizens Coalition v. Minnesota Public Utilities Commission*, 355 N.W. 2d 295, 300 (Minn. 1984); *Allain v. Mississippi Public Service Commission*, 435 So. 2d 608, 613 (Miss. 1983); *Pacific Power & Light Co. v. Public Service Commission*, 677 P.2d 799, 805 (Wyo. 1984), *cert. denied*, 469 U.S. 831 (1984); *Committee of Consumer Services v. Public Service Commission*, 595 P.2d 871, 874 (Utah 1979), *cert. denied*, 444 U.S. 1014 (1980); *In re Petition of Jersey Central Power and Light Co.*, 85 N.J. 520, 428 A.2d 498, 502 (N.J. 1981).

The OCA reiterates that it does *not* contend that the used and useful principle is constitutionally *required*. Many states, as a matter of law or policy, have permitted exceptions to the strict application of the used and useful principle. Indeed, Section 1315, the provision of the Pennsylvania Public Utility Code at issue here, exempts investments in such items as pollution control and safety-related facilities from the used and useful requirement. 66 Pa. Cons. Stat. §1315 (1987). The Pennsylvania Public Utility Code has now even been amended to permit recovery of certain cancelled plant costs — a provision which has enabled Duquesne to begin recovery of its $154 million share of its recently abandoned Perry 2 plant. 66 Pa. Cons. Stat. §520 (1987). *See* OCA Motion to Dismiss or Affirm at 50-52. These are matters of public policy, however, not constitutional law.

In his concurring opinion in *Jersey Central, supra,* 810 F.2d at 1190-91, Judge Starr criticized the sole reliance on *either* the prudent investment *or* the used and useful standard without regard to the overall balance of interests of investors and ratepayers in establishing just and reasonable rates. Judge Starr's analysis of these two standards is instructive, however, in demonstrating why it is not appropriate to adopt a single constitutionally mandated ratemaking policy. As noted by Judge Starr:

> Prudence is, of course, relevant to the process of striking a reasonable balance in rate-setting for public utilities. Requiring an investment to be prudent when made is one safeguard imposed by regulatory authorities upon the regulated business for benefit of ratepayers. As I see it, the "used and useful" rule is but another such safeguard. The prudence rule looks to the time of investment, whereas the "used and useful" rule looks toward a later time. The two principles are designed to assure that the ratepayers, whose property might otherwise of course be "taken" by regulatory authorities, will not necessarily be saddled with the results of management's defalcations or mistakes, or as a matter of simple justice, be required to pay for that which provides the ratepayers with no discernible benefit.

> The two principles thus provide assurances that ill-guided management or management that simply proves in hindsight to have been wrong will not automatically be bailed out from conditions which government did not force upon it.

Id. at 1190 (footnote omitted). Judge Starr further noted that:

> The obvious danger in not examining both ends of the continuum—both the prudence of the investment and whether the end result of the investment was used and useful—is to build in pressures for building excess generating capacity. The "used and useful" rule operates as a restraining principle, reminding utility managers that they must assume the risk of economic forces working against an investment which is prudent at the time it is made.

Id. at 1190 n.1.

This Court has recognized that "the regulation of utilities is one of the most important of the functions traditionally associated with the police power of the States." *Arkansas Electric Cooperative Corp. v. Arkansas Public Service Commission,* 461 U.S. 375, 377 (1983). Different states have chosen different methods of allocating the risks and costs of utility facilities between investors and ratepayers. It would be extremely disruptive to the states' legislative and regulatory processes if this Court were to reject the teachings of *Hope*, and impose a single constitutionally mandated ratemaking methodology. In addition, such a ruling could plunge this Court, as well as other state and federal appellate courts, into the position of reviewing every element of every utility rate order on a constitutional basis. After all, if utilities have a constitutional right to a fair return on all of their prudent investments, then *every* rate disallowance arguably would have a constitutional dimension since every disallowance affects the investors' ultimate level of return.

The OCA respectfully urges this Court to refrain from imposing a single constitionally mandated ratemaking standard on all state and federal regulatory authorities. To impose such a standard would

be to return this Court to the pre-Hope era, where every ratemaking disallowance raised constitutional issues and the state and federal regulatory agencies were paralyzed in their attempts to set rates in a fair and economically efficient manner.

By insisting on the utilities' constitutional right to a return of and on individual items of property, the Appellants and their Amici would effectively re-establish the eminent domain theory of ratemaking, with one important modification. That is, the property on which they demand compensation in this case is absolutely worthless.

There is no basis in law for utilities to claim a constitutionally guaranteed right to either a return of or a return on useless investments. The prudent investment standard proposed by the Appellants and Amici should be rejected.

CONCLUSION

Near the end of the *Hope* Opinion, Justice Douglas observed that, if the rates upheld in that case proved to be inadequate, "the doors of the Commission are open for increased allowances." 320 U.S. at 615.

As the ratepayers of Duquesne Light Company and Pennsylvania Power Company have become painfully aware, the doors of the Pennsylvania Public Utility Commission are open as well. During the last decade, both Duquesne and Penn Power have been before the Commission with numerous rate increase requests. Those requests culminated in the last several months with phased rate increases totalling $232 million, or 29 percent, for Duquesne, and $67 million, or 38 percent, for Penn Power.[9]

The *Hope* decision put an end to the era in which utilities could come to this Court demanding constitutional protection for

[9] *Pa. PUC v. Duquesne Light Co.*, R-870651 (Pa. PUC March 25, 1988); *Pa. PUC v. Pennsylvania Power Co.*, R-870732 (Pa. PUC May 3, 1988).

specific rate claims or insisting upon the application of certain ratemaking methodologies. Under *Hope*, if the overall rates permit the utility to operate successfully, then constitutional review — from the utility investor viewpoint — is at an end. If the utility would like to operate even more successfully, "the doors of the Commission are open for increased allowances" if such allowances are found to be lawful and appropriate.

The Appellants here have not met the threshold requirements for raising a confiscation claim under Hope. Even if they had, however, the OCA submits that the Pennsylvania ratemaking policy and statute at issue here are constitutionally permissible and economically sound.

The Opinion and Order of the Pennsylvania Supreme Court here on appeal must therefore be affirmed.

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